Financial Democratization

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Abstract: This paper reviews the literature about the relationship between the financial system and good governance. Since a substantial body of scholarship demonstrates the importance of good governance to financial sector performance, the paper examines evidence about the ways in which the financial system affects governance, which is defined as the transparency, predictability, and accountability of government. The mechanisms by which the financial system influences governance include signaling, substitutes, distribution of assets, economic growth, neutral rules, market power, and pluralistic structure. The paper explores each and suggests the implications for foreign assistance policy designed to promote both economic growth and good governance.

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A. Introduction

Does a deep, broad financial system contribute to good governance? Do some financial markets or instruments do so? What do the answers to these questions suggest for development initiatives, particularly those undertaken by USAID? This paper reviews the evidence for financial democratization, which is defined here as the role of the financial system in promoting and sustaining good governance.*

For purposes of this paper, good governance describes a political system that is transparent, predictable, and accountable to those it governs (Root 1996, at 177).** This broad concept is related to concepts of the rule of law and civil society. The conference for which this paper is prepared addresses the full range of characteristics of good governance. Here I ask how, in theory and practice, the financial system of a country does, or could, affect the transparency, predictability, and accountability of government and affect the rule of law and civil society.

The literature linking finance to governance is quite limited, but it suggests that finance affects governance through seven mechanisms (parentheses indicate the labels used in the governance literature): signaling, the existence of certain substitutes for formal financial services (informal financial

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* This paper reviews the line of causality from finance to governance because the causal links in the other direction are well established in the literature. Despite an intermittent debate about whether financial intermediaries and markets would be more efficient without regulation, the weight of the literatures supports the view that good governance is very important for a financial system to allocate savings efficiently. See, e.g., Stiglitz (1991). This paper also does not investigate the relationship between financial systems and a country's use of authoritarian or democratic techniques to select governments. This choice is assumed to be the result of so many variables that the financial system plays a limited role, if any.

** Another approach is to define governance in more general terms. For example, the World Bank defined it as "the manner in which power is exercised in the management of a country's economic and social resources for development." Quoted in (Isham et al 1997), who recognize that "openness, transparency, predictability, and the rule of law" "induce government behavior" (citing Bautigam 1992).

markets and criminal activities)), distribution of financial assets (equitable distribution of wealth and income), economic growth, the infrastructure of financial regulation (providing neutral rules), market power (limiting central government power), and market structure (pluralism). One cannot describe this as the conventional wisdom because relatively little has been written about the specific role of the financial system.

This paper examines each of these seven mechanisms, drawing primarily on the experience of countries in Asia. Each mechanism can be complicated. For example, simply broadening equity ownership through privatization does not automatically and directly contribute to good governance. Other factors, such as the structure of the financial system, the regulatory regime, and the sophistication of the investors, play important roles. These factors must be taken into account in any privatization project intended to use the financial system to promote good governance.

Each of these mechanisms raises issues explored in an enormous literature. For example, an analysis of the impact of voucher privatization leads to theories of corporate governance, which may have direct implications for good governance. These issues are not normally treated as part of the financial system, so this paper does not pursue them in any detail. Moreover, the topics in this paper overlap with other topics presented in the conference. For example, the market power mechanism includes decentralization and fiscal federalism. Regulation affects corruption. I note but do not explore these overlapping topics.

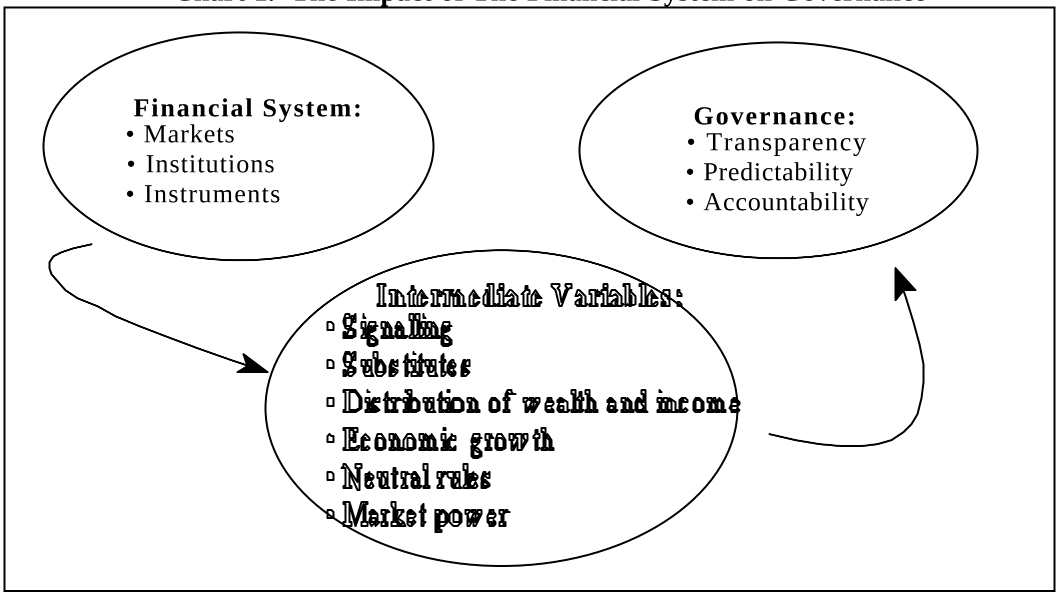
The broad operational implications of this analysis are that (1) theory offers some limited guidance to promote financial democratization at the level of a project or program, (2) a stronger case can be made for developing the financial system generally than for developing individual financial markets, entities, or instruments, and (3) efforts to develop individual markets, entities, or instruments, as well as the evaluation of their performance, should be very closely related to the broader economic and political context and sensitive to the long time it takes to create lasting institutional change.

The following sections review the literature to identify relevant aspects of the financial system (the independent variable), their effect on the linking mechanisms (intermediate variables), which in turn promote good governance (treated here as the dependent variable). In fact, of course, causality is multidirectional. The sections raise some policy implications for development assistance.

B. The Paradigm

Many factors affect good governance. Social, cultural, political, and economic forces all play a role. It is difficult, therefore, to identify the direct impact on governance of the financial system or even less the effect of an individual financial market, institution, or instrument. One can, however, identify factors (or intermediate variables) that are known to affect governance and then examine the way in which the financial system affects these factors. Chart 1 presents an overview of these factors.

Chart 1. The Impact of The Financial System on Governance



The link from five of the seven intermediate variables to governance is described in the literature about governance. Neutral prudential rules, the equitable distribution of wealth and income, economic growth, limitations on the central government, and a pluralist relationship between interest groups and government have been found to contribute to good governance in Asia. Two other factors, signaling and the role of substitutes (informal markets and crime) supplement those identified in the literature about Asia. I explain these links in the next section.

This paper examines critically the link from the financial system to the intermediate variables. If the financial system (or its components) do affect any intermediate variables, then we can fairly assume an effect on governance.

C. Mechanisms by which the Financial System May Affect Governance

The literature on good governance describes the factors that may affect governance. The following paragraphs present seven factors that may be intermediate variables linking the financial system to governance. Several attract debate, as noted below.

The link between ***neutral prudential rules*** and transparency, predictability, and accountability is obvious. Rights-based laws are transparent, their application is predictable, and those making, administering, and enforcing them are accountable, particularly through judicial review (see Pistor and Wellons 1997).

A broader ***distribution of wealth and income*** promotes good governance through a complex set of steps. Campos and Root (1996) found that distribution of wealth and income affects the political process in Asia. "Wealth-sharing mechanisms signal the polity, especially those near the bottom of the economic pyramid, that they will share in the benefits of growth. Thus these measures help persuade nonelites to make sacrifices needed to initiate and sustain economic growth." The authors concluded that a wide variety of mechanisms, ranging from improvement of land ownership through programs to support small and medium-sized enterprise, had this effect. "All these mechanisms make the broader population more cooperative, willing to make sacrifices in the expectation of future returns" (Campos and Root at 75). A skeptic might say that this would appear to justify sacrifice in the present, but not automatically produce good governance. Indeed, one might even expect it to have the opposite effect, permitting the government to continue to act with limited transparency or accountability. Root answers the skeptics by saying that wealth-sharing indicates a basic social and political structure.

Broadly, wealth sharing is a major element in the dominance of "horizontal relations of reciprocity and cooperation" over vertical ones "that intensify social cleavages" (Root 1996, citing Putnam 1993) in certain countries of Asia. Sharing was notably absent, Root found, from some of the less dynamic countries, such as the Philippines. The shared benefits of growth were essential for the growth of a neutral bureaucracy that relied on merit (citing Max Weber's notion of bureaucratic rationality). It permitted, within the bureaucracy, achievement to take precedence over favoritism based, for example, on familial ties. Root concluded that sharing promoted an evolution toward the elements of good governance -- transparency, predictability, and accountability -- even under the political systems that were more authoritarian than democratic during the early decades of the East Asian miracle. In this way, he explained, a country can have good governance even with limited democracy.

This analysis requires ***economic growth***, since it is the benefits of growth that the general populace expects to share. Economic growth also correlates positively with government credibility, defined as the "citizens' level of trust in government to carry out its declared policies and to meet its obligations" (World Bank 1996 at 94). The World Bank cites a study of 28 countries, including transition countries, using economic data for the 1980s and public opinion polls conducted in 1992. While this study does not imply causality, it suggests an important relationship between economic growth and governance.*

The ***type of relations between interest groups and the state*** affects governance. One exponent explained the two types of relationships, pluralist and corporatist (Wade 1990 at 27),

> In pluralist regimes, interest groups are voluntary associations, free to organize and gain influence over state policy corresponding to their economic or political resources. The process of government consists of the competition between interest groups, with government bureaucracies playing an important but not generally dominant role. In corporatist systems, the state charters or creates a small number of interest groups, giving them a monopoly of representation of occupational interests in return for which it claims the right to monitor them in order to discourage the expressions of 'narrow,' conflictual demands. The state is therefore able to shape the demands that are made upon it, and hence--in intention--maximize compliance and cooperation....

A second set of variables characterizes the way countries pick their leaders as either democratic or authoritarian. A country may combine the two sets in various ways: the U.S. is pluralist democratic, Switzerland or Austria corporatist democratic, and Japan corporatist with a combination of democratic and authoritarian, according to Wade. Wade argued that "the corporatist and authoritarian political arrangements of East Asia have provided the basis for market guidance" (Ibid). This guidance generally undercuts at least one element of good governance, since it is not transparent. In addition, those exercising guidance may not be accountable to groups outside the bureaucracy nor are their decisions necessarily predictable, depending on the country. So a country may have a democratic form of government, but the relations between interest groups and the state make it possible for the government to play a direct role in the economy and to do so without the transparency that good governance requires. Pluralist rather than corporatist relations are needed for good governance, in this view.

Some ***substitutes*** for formal financial services hurt good governance. Informal markets operate with limited transparency and may facilitate corruption. Corruption and organized crime undercut good governance and a civil society in many ways that are the topic of another session in this conference.

Similarly, fiscal decentralization, one aspect of the ***decentralization*** of power, is another topic of this conference. Here the notion is that good governance is facilitated by factors that reduce the central government's capacity to act arbitrarily.

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* This is different from the question of whether democracy helps or hinders economic growth. Recent studies "find no causal link at all between democracy and growth." (See the literature review in Isham et al 1997 at 220-1).

The role of ***signaling*** is not obvious in the literature about good governance. It is advanced here because of the importance of information in the finance literature. I start with it.

Overall, a major effect of the deeper, broader financial system would be to increase the efficiency with which financial and real resources are allocated. Such a system would offer a sustainable source of funds for the economy and the government. One would expect that both efficiency and sustainability would contribute to good governance.

A more detailed picture of the relationships between the financial system and good governance is given in Table 1.

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D. The Financial System and Signaling

Financial markets bring the political economy of the country into the spotlight of informed public opinion. Assume a government manages its economy poorly. It is likely to be able to cover up the extent of its problems longer if it can manipulate closed domestic financial markets than if it must work with an open public capital market. When financial markets signal their evaluation of government performance, governments take notice.

Information is at the core of financial theory. Market behavior is a function of available information.* The response of financial markets to data about an issuer's risks and opportunities conveys important information to investors and observers of those market. For this paper, the important fact is that players in financial markets seek information about political or other events, the economic policies of a government generally, and the performance of an economy, and render often lightening judgments about their expected effect. The rapid informed judgments of a deep broad market contrast in speed and accuracy with those of a managed market. One would expect that a government subject to the constant evaluation of financial markets would behave differently, presumably in a much more constrained manner, from one not subject to perpetual judgment.

The relevant question is how market signals about a country and its risk (or even about markets within a country) affect the political process. I found no systematic analysis of the way that domestic financial markets affect domestic politics in developing countries or about the relative impact on the political process of signals from a managed financial market compared to a more open one. Certainly the U.S. Treasury and other government agencies watch U.S. financial markets for signals about the predicted effect of their policy and recent administrations respond to, or even anticipate, these signals in their actions. International financial markets signal in ways that affect the governments of developing countries; the markets' impact on Thai policy in 1997 is a fresh example and one sees the impact in the lending that led up to the 1982 debt crisis as well. But the impact in these examples is directly on the borrowing capacity of the country rather than indirectly on government as a political actor or, more broadly, on governance.

This appears to be an unexplored and potentially important area for understanding financial democratization. The basic question is whether and how financial market signals affect good governance. An area of further inquiry, based on the idea that market signals give a point of view reflecting the players' interests, would be to learn if the signals change with the mix of players. That is, do the signals vary depending on whether the group of financial market players is narrow or broad? Or does the interpretation of the signals vary? If a financial market merely relates economic risk and reward, its signals should be independent of the character of its players.

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* The efficient markets hypothesis pervades the finance literature, for example.

A second area of inquiry would be to determine the impact on governance of financial markets that misread economic conditions. The signals sent by financial markets do not invariably reflect the state of the underlying economy. Many have noted the herd instinct of players in financial markets. A stark example is the Mexican foreign exchange crisis beginning in late 1994. One's label of the behavior that constituted herding depends on one's interpretation of the nature of the crisis. For those who conclude that the peso was seriously overvalued from at least mid-1994), the continued cross-border lending and investment into Mexico during 1994 is a case of herd behavior, in which the investors ignored or misinterpreted the underlying economics. For those who conclude that the peso was reasonably valued during that period, then the herd moved in December 1994, bringing about a steep but uncalled for devaluation in the peso against the dollar.

The implication of this analysis is that USAID should help government officials learn to respond to financial market signals in market-oriented ways. The officials need to learn when to bend, when to hold, and how to do either. For example, in Indonesia in the early 1980s, the central bank had introduced a weekly auction of short-term government notes in order to develop the country's money market. The major buyers were government-owned banks. When central bank officials became concerned about volatile interest rates, they would telephone one of the leading state-owned banks and tell it what to bid. Needless to say, the money market developed slowly (Cole, Scott, and Wellons 1995). The regulators needed to be open to the market signals. Learning how respond to the signals would help.

E. The Financial System and Market Gaps

That a formal financial system does not perform all functions normally associated with it does not mean the functions go unperformed. The entities that fill these market gaps may affect governance. The common functions of a financial system include (Cole and Wellons 1989, Stiglitz 1993, for capital markets):

- provide a safe place and form in which to hold savings at a low cost measured in real resources;
- mass capital from small savers for large investments;
- transfer control over resources from savers to users at low transactions costs compared to alternatives;
- match savers and investors with congruent preferences for risk and return;
- monitor the use of the resources and pressure users to be efficient and productive;

- reward efficient and capable financial managers;
- enforce repayment;
- maintain a stable numeraire;
- provide a safe efficient payments system;
- transfer, share, and pool risk;
- diversify risk; and
- generally minimize vulnerability to panic, crisis, and collapse.

The financial systems of many developing countries do not do all these tasks. They may lack the human, institutional, and other resources to perform them. For example, banks in many countries do not have sufficient personnel with the skills to evaluate the creditworthiness of borrowers efficiently. Their staffs may not be paid or policed enough to insulate them from bribery in making credit decisions. Financial systems may have been prevented by government from performing the functions. For instance, the government may restrict the entry of new banks or branches, limiting the distribution of banking services across the country or among different parts of the population.

In developing countries, substitutes often do jobs that a formal financial system does not perform but for which demand exists. Informal financial markets can do this in many ways. They can, for example, lend to small or fringe borrowers who do not qualify for loans from banks. Under some conditions, such as very high marginal tax rates or exchange controls with seriously misaligned rates, informal markets play a substantial role. To the extent that these markets operate with limited data or formal rules, they are in a system that is not transparent, predictable, or accountable. Good governance is less feasible.

Operationally, this suggests the need to focus on the roles performed by informal financial markets. A huge literature describes this, supported in large part by USAID. For this paper, the argument is that many developing countries face a difficult choice. At a national level, good governance appears to require formal markets that are more transparent, predictable, and accountable than informal markets can be.* At the local level, however, in many developing countries

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* Some informal financial markets, of course, are relatively more transparent and predictable than others. An example would be the curb market in Korea. Moreover, as economies develop and financial systems become more complex and liberalized, the role of the informal market diminishes. Korea's curb market essentially ended in the early 1990s, for example.

the informal markets may promote good governance and effective financial intermediation for years to come (see, e.g., Shipton, Vogel, and Wellons 1994). Once one has identified the function and role of informal markets at different levels, one can determine how to intervene in informal markets, if at all. This links to issues of fiscal decentralization, discussed elsewhere in the conference.

Organized crime, notably but not only in transition countries, provides substitutes in some financial systems. In Russia, the mafia fill market gaps, according to the World Bank, by collecting loans owed to banks. Indeed, "a significant number" of Russian banks have close ties to the Russian mafia. The benefits of this substitute service for formal banking (and supporting legal system) are offset by the costs: the gangs "force 'loans' out of banks, ... and use banks ... to gain access to wealthy clients. They... launder illicit income" (World Bank 1996). The important point is that the activity of these substitutes can take place in part because of gaps in the financial system. The implications of this analysis for USAID are that the gaps in the financial system should be filled.

As the formal financial system comes into its own, it can displace these substitutes. In this way, it promotes good governance by reducing organized crime. Moreover, the steps that would promote an effective formal financial system are the same, according to the World Bank, as those that would reduce corruption: rapid transparent "privatization, liberalization, and demonopolization, ... simplifying taxes and regulations, ...and clarifying property rights...." (World Bank 1996 at 96). These go to the transparency, predictability, and accountability of government.

F. Financial Markets, the Distribution of Income and Wealth, and Economic Growth

Finance could affect governance through its impact on levels of economic growth and the distribution of income and wealth. Since growth and distribution have important consequences for governance, a financial system that affects them for good or ill could be significant. For example, if a deeper financial system permits greater economic growth, then financial depth should promote good governance. If certain financial structures lead to more equitable distribution of wealth, then those structures should promote good governance.

1. The general impact of the financial system:

The fundamental debate about the role of the financial system in economic development is whether finance leads, evolves with, or follows economic growth. The finance-follows-growth view is often attributed to Joan Robinson (1952). Broadly stated, the notion is that financial institutions respond to demand for services rather than create the demand. One finds intuitive support of this view in the history of banks' expansion: banks tended to follow, rather than lead, their clients at home or abroad. When Bank of Boston, at the turn of the century, discovered that important borrowers based in Massachusetts were setting up operations in Argentina, the bank established its own units in Argentina to serve the Boston customers there. The bank was motivated not only by profit opportunities, but also by the need to protect its customer base at home from competitors there. Other Boston-based banks might lend to these firms abroad, establish a relationship there, and then use it to lend to the same firms back in New England. This view implies that development efforts should concentrate on the real economy and let the financial system respond to demand for financial services that arise from growth.

The weight of the literature about finance and development runs counter to the view that finance simply follows growth. It finds at least a correlation between financial and economic development. Specifically, financial depth and breadth are associated with ***economic growth***. Several waves of literature try to assess the relationship.* Schumpeter tackled the question when he published his theory of economic growth over 85 years ago (Schumpeter 1911). In the 1960s and early 1970s came another wave. Goldsmith (1969) observed the relation between financial and economic development. McKinnon (1973) and Shaw (1973) found that financial deepening, measured, for example, by comparing the size of the banking sector against GNP, increased the domestic saving rate, which lowered borrowing costs and prompted investment. In the 1990s, urged by the needs of the transition countries, came the next wave. Financial markets were found to develop as part of endogenous growth, with economic growth generating resources to support the evolving financial markets, which in turn support further growth (Greenwood and Smith 1997).

Both correlation and causality are tackled in a broad cross-country study by King and Levine (1993). Their measures of financial development were financial depth (the ratio of liquid liabilities to GDP), the relative importance of commercial banks in the financial system (the ratio of domestic bank credit to central bank credit), and the relative importance of credit to private borrowers (the ratio of credit to nonfinancial firms compared to total credit to non-banks, and the ratio of credit to nonfinancial private firms compared to GDP). They found a partial correlation between finance and growth from 1960-89 in a set of 80 countries. “Higher levels of financial development are positively associated with faster rates of economic growth, physical capital accumulation, and economic efficiency improvements both before and after controllng for numerous country and policy characteristics” (King and Levine 1993 at 719-20).

Testing for causality, they found that the level of “financial development... is a good predictor of long-run growth over the next 10 to 30 years. ... Higher levels of financial development are strongly associated with future rates of capital accumulation and future improvements in the efficiency with which economies employ capital” (King and Levine 1993 at 719).

Causality remained a problem in the studies. Did some third factor, like savings rates, account

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* This view has been around for well over a century. Bagehot argued in 1873 that improvements in the financial system would accelerate economic growth (Bagehot 1873, cited by Levine 1997 at 27).

for the growth of both? Did the financial markets simply anticipate growth, discounting and capitalizing its effects in the present and thus acting as a leading indicator rather than a cause of economic development? Rajan and Zingales (1993) addressed this issue. They noted that some industries relied more on self finance, while others relied on financial sources outside the firm (external finance). Pharmaceuticals, for example, had long lead times developing new products, requiring substantially more external capital than textiles. The authors asked if industries that relied on external finance grew relatively faster than other industries in countries with financial systems that were deeper than those in other countries. They determined industries' dependence on external finance using data from the U.S. in the 1980s. They measured financial development as equity market capitalization over GDP, domestic credit over GDP, private credit over domestic credit, and per capita income. The 44 countries they examined included industrial and developing countries on all continents.

Their findings "suggest that the ex ante development of financial markets facilitates the ex post growth of sectors dependent on external finance. This implies that the link between financial development and growth identified elsewhere may stem, at least in part, from a channel identified by the theory: financial markets and institutions reduce the cost of external finance for firms." (Rajan and Zingales (1993) at 3). One of the principal limitations, which the authors acknowledge, is that they must rely on U.S. experience to determine the dependence of firms on external finance. This assumes that the dependence reflects technological factors that are universal. In fact, the structure of a country's financial system may also play an important role.

In a study of the links between law, finance, and economic growth, Levine drew on legal indicators in some 43 countries. He found that countries with strong laws for security interests, contract enforcement, and financial reporting had better-developed financial intermediaries. He reported that his findings "were consistent with the view that improvements in creditor rights or the enforcement of contracts, or the information content of corporate financial statements induce improvements in the functioning of the financial intermediariees that accelerate economic growth" (Levine 1997 at 22).

Analyses of the relationship between the financial system and the ***distribution of income and wealth*** are fewer. To the extent the financial system affects growth, and growth is associated with income equality, the financial system would be associated with the distribution of income. Indeed, the World Bank reported that income inequality was associated with slower growth in a survey of 37 countries from 1965 to 1989 (World Bank 1991 at 137). The formal theoretical link between financial development and income distribution was developed by Greenwood and Jovanovic (1990). Their model relied only on endogenous development (rather than an exogenous change in, for example, technology). In their model, "financial intermediation promotes growth because it allows a higher rate of return...on capital" and "growth ... provides the means to implement costly financial structures" (Greenwood and Jovanovic 1990). As the economy developed from simple slow growth to more specialized faster growth, income distribution would first become less equal as savings were massed through intermediaries to finance the shift. Then, as the economy matured, income distribution would become more equal.

The implication of this literature is that projects to deepen and broaden the financial system contribute to good governance by promoting economic growth and eventually a more equitable distribution of income and wealth. A huge literature describes approaches to financial development. The following sections examine two major components, markets for equity and bank credit. Although I do not compare the relative virtues of credit and equity, it is worth noting that one seam in the literature describes certain circumstances under which equity markets are inferior to markets for bank credit (Stiglitz 1991).

2. Equity markets and voucher privatization.

It is difficult to find strong evidence that equity markets or specific forms of equity interests, such as voucher privatization, contribute to good governance. Compared to financial intermediation generally, the links between equity markets and economic growth are still more tenuous in theory and empirically. The functions that equity markets perform have been performed in other ways in the past; Japan and Germany are common examples of countries that relied on banks rather than stock markets to mass savings for industrialization. But over the last twelve years, equity markets have grown into an important source of funds for companies in many countries around the world. The literature may be weak simply because the role of equity markets is relatively new.

a. *Broad equity markets and the distribution of wealth and income*

In the abstract, when a large part of the population holds shares in many companies, the holders may have a stake in the economy and the way it is run, and act to protect it. Their interest differs, in this view, from the stake any citizen has in the country's economic performance because the market's performance is continuously valued and publicly known. It has a measurable and immediately observable impact on the holder's income and wealth. A strong performance of the equity market demonstrates to the holder the benefits of a market economy. This view has a certain appeal but turns out to be simplistic.

At a systemic level, one cannot begin to demonstrate a direct effect between broad share ownership and good governance unless one is prepared to describe certain forms of European governance as less good than American. America has had broad deep stock markets for decades. German stock markets played second fiddle to credit markets for decades and are only beginning to come into their own. I will not try to demonstrate here that Germany's government is less transparent, predictable, or accountable than that of the U.S. The different roles of the stock markets in the two countries do not correlate with different governance. Absent a much more thorough analysis, it appears that a country can achieve good governance without a strong stock market and widely held shares.

The question remains whether encouraging broad ownership in stock markets helps promote good governance. Broad equity ownership may not be essential, but is it a useful tool, particularly in countries that lack a tradition of good governance?

The belief that corporate governance has political implications stems at least from after the second world war. Soon after it ended, the structure of corporate ownership in Japan "changed rapidly from one of wide distribution among individuals to one of institution-centered ownership with extensive cross-holdings" (World Bank 1996 at 109). The occupying American forces had broken up the Zaibatsu, which were believed to have worked closely with an increasingly militaristic Japanese government in the pre-war years. It was thought that wide distribution of ownership would help prompt the government to favor peace over expansionist militarism. The policy toward ownership changed when the Western powers came to see an economically strong Japan as a bulwark against Chinese communist expansion in Asia after the Korean war. While this paper cannot examine corporate governance in detail, the point is important.

Recent theoretical analysis suggests that equity markets do not necessarily enhance growth but that they can do so under certain conditions (Greenwood and Smith 1997 at 148). There is some empirical evidence, though, that broad deep equity markets correlate with economic growth and equitable distribution of income and wealth. Rajan and Zingales, described above, used equity market capitalization over GDP as one measure of financial growth and found that this measure facilitated growth of sectors that depended on external finance.

The evidence of this correlation would appear to run counter to the case of Japan, where the cross-holding of shares by group members and limited equity markets ushered in an era of remarkable growth that continued far beyond recovery from the devastation from the war. The structure of the financial system in Japan permitted a corporatist system, described above, which some believe to have undercut both markets and good governance in several ways. Cross-holding served as one tool of market guidance. It was part of a system that generally did not need or want transparency or accountability to the general public. It limited broad public involvement in Japan's equity market. A simple example is a financial industrial group with 15 companies as members. Every company holds 5% of the stock of each of the other group members. For any single company, 70% of its stock (5% times 14) will be owned by other group members. Even if its stock is listed, only 30% is publicly traded. Control cannot be acquired in the public stock market. One of the major functions of equity is absent from the stock market. Cross-holding may have contributed to the asset bubble in the late 1980s by permitting a speculative boom in a market that was shallow even though it was big. Today Japan's financial system is undergoing radical surgery to repair very serious problems. Some say that in the long run the system proved unviable. Others say it served its purpose well, which was to help in the forced march of Japanese economic recovery, but outlived it. These interpretations would have very different implications for foreign assistance.

The reliance on capital markets to promote economic growth is misplaced, according to some observers. Stiglitz argues that equity markets are not important sources of capital in industrial countries and will not be important in transition countries. "One cannot expect equity markets to play an important role in raising funds in the newly emerging democracies. Equity markets are also a sideshow in the allocation of capital. ... The stock price is relevant ... but ...it simply provides information [rather than guiding basic business decisions].... The stock market does enhance liquidity..." (Stiglitz 1993 at 32).

Transition countries confirm Stiglitz's view. So far, relatively little has been raised on their capital markets. According to the World Bank (1996 at 107):

> In CEE and the NIS only the best firms have ben able to raise any financing, altogether less than $1 billion from 1991 to 1995. In China new equity offerings have been comparatively large, amounting to more than $1 billion in 1993 alone. They still, however, account for only a small portion of total enterprise investment. ... Turnover on formal markets is ... low. In very few countries has equity trading been active and had a disciplinary effect on managers.

The Bank points out that despite rapid privatization and a fast growth in capitalization, trading has been very low by international standards, "because demand is low and institutions are weak" permitting frequent "outright fraud."

Recent work, however, identifies stock markets as important sources of funds in many developing countries. An IFC study shows that in developing countries firms make substantial use of external (equity) finance. In each of nine emerging markets, the 100 largest listed companies financed 39% of their new investments by issuing equity (Singh 1995). Suppose that stock markets could become a significant source of funds for firms in other developing countries. The mechanisms by which the market could contribute to good governance are those cited earlier: increased economic growth, a broader distribution of wealth and income, and neutral regulation.

A trade-off may exist between a broad liquid stock market and effective governance of corporations, at least in transition countries. In countries that lacked the institutions needed to let the equity markets work effectively, like the transition countries, the World Bank concluded that:

> increasing ownership concentration leads to illiquidity, especially in formal markets. In many transition economies with mass privatization programs, investors have held on to their stakes after the initial round of trading. Trading often occurs in blocks off the formal exchanges--such is the case with 80 to 90 percent of shares exchanged in the Czech Republic--as investors try to build up controlling stakes. Other countries show a similar tradeoff between

> concentration of ownership and market liquidity. Given the lack of sound corporate governance and scarcity of financial skills, concentrated outside ownership (combined with monitoring by banks) has its advantages in most transition economies. At least in the short run it is probably preferable to highly liquid and speculative capital markets that may impose little or no discipline on managers...." (World Bank 1996 at 109).

This suggests that, at least in countries with weak financial and regulatory institutions, one cannot expect projects to promote successfully both good governance (by diversifying wealth and income) and effective corporate governance. The drive for the economic goal of control (corporate governance) will overwhelm the distributive effects, at least into the medium term.

Demand-led projects may be the most effective, even though the process can be slow, since as equity markets broaden, they generate demand for transparency and predictability. Equity market players demand better rules: "More-effective rules and institutions tend to develop when they advance in step with demand and supply, rather than behind or well in front of them. ... In Russia, a system for over-the-counter trading in stocks and rules governing trades were introduced because brokers realized that it was in their own interest to share information with others and agree on common standards." (World Bank 1996 at 107). The Bank pointed out that the government must still support capital market development by "promoting the necessary institutions and in vetting the rules of the game...."

This analysis, based on limited recent experience, suggests that it is too optimistic to hope to develop equity markets and good governance simultaneously by quickly broadening the distribution of wealth and income in the many countries with weak institutions. An alternative is to proceed in stages: develop the institutions with, or slightly ahead of, demand. For practical purposes, this would imply building gradually toward rules based on disclosure rather than direct governmental involvement. Merit regulation, in which the government evaluates the risk of potential issuers, is seen as the opposite of a disclosure system which ensures that the investing public learns of all risks and accepts the risk of loss. Merit regulation may legitimately respond to data inadequacies caused by weak accounting and auditing, insider control, and other factors. It may be a mistake to advocate unleavened disclosure while these limitations are severe. Although no systematic evidence demonstrates that certain types of regulation lead to good governance, one sees suggestions of the link. For example, Taiwan and Malaysia both recently moved away from a merit system of regulation to one of more disclosure (Wong 1996). This was a shift from less transparency to more, but not to complete transparency. Neither country instituted a full system of disclosure, so the government regulators could continue to play a direct role in the markets of both countries. Technical assistance to help countries move gradually toward systems based more on disclosure could be valuable. More generally, technical assistance to improve the transparency and predictability of equity markets and their regulation would eventually help both the economy and the governance of the countries. This mechanism could ultimately link equity markets and good governance.

b. ***Good governance and techniques to broaden shareholding: The case of voucher privatization.***

Mass privatization using vouchers would appear to be a prime candidate for financial democratization. Used in many transition countries, this was a technique to privatise large numbers of state-owned enterprises (SOEs) over a brief period of time. It distributed to the public vouchers that were certificates giving the right to obtain shares. The holders could exercise the vouchers to acquire, depending on the country, shares in the privatized SOEs or in investment funds that would hold the SOEs' shares. Mass privatization contrasted with other techniques, such as selling individual firms to strategic private investors or issuing shares in public equity markets, both in form and in benefits to the government. While the government would be paid for its stake in firms privatized through sales to strategic investors or the investing public, it would receive from voucher privatization at most only a very limited servicing fee from recipients of the vouchers. The Organization for Economic Cooperation and Development (OECD 1995 at 16) described the overall objectives of voucher privatization:

> a) political: attempting to involve and commit the population at large to the economic transformation process;
>
> b) social: seeking some form of distributive equity through the distribution of shares to the general public; and
>
> c) economic: quickly privatising a large number of firms to deepen market forces and competition in the economy.

The political and social goals attest to a general interest in good governance. The OECD said that countries used vouchers "to assure a more fair and equitable distribution of the wealth previously held by the state" (OECD 1995 at 18).

Voucher privatization takes several forms. Pistor and Spicer (1996) identify three according to the degree to which the government is involved in the process of investing.

- In the *free market model*, the state merely designs the process. Individual voucher holders decide whether to invest directly in firms or indirectly through investment funds, which can be freely created. Individuals and funds compete for shares of privatized SOEs in auctions. This model was adopted by Russia and the Czech Republic, and in some stage of implementation in Bulgaria, Georgia, Kyrgystan, Lithuania, Moldova, and the Ukraine.

- The *restricted market model* prohibits individuals from investing directly in privatized SOEs. Instead, they must invest in private funds, and the government limits the number of funds.

Funds alone can bid for the shares of privatized SOEs. Kazakstan and Uzbekistan use this.

- Even more constrained is the *regulated market model*. It embodies all the limits of the restricted model and the government sets up the funds, which then sell their shares to the public. The government also makes detailed rules about portfolio composition and situations in which the fund must hold controlling or only minority stakes. Only Poland has this type.[*]

Pistor and Spicer evaluated the performance of voucher privatization in the Czech Republic and Russia, the only countries with a sufficiently long track record and data to permit analysis. Both countries used the free market model. Emphasizing that their small set of countries called for wider analysis, they concluded that voucher privatization had not accomplished its basic goals. other than to shift ownership rapidly from government to private hands.

Voucher privatization in Russia and the Czech Republic did succeed in dramatically reducing the number of state-owned enterprises. Russia started with 25,000 SOEs and privatized oer 8,200 by the end of 1993, accounting for about 70% of labor in manufacturing. The process also involved large parts of the population: almost 150 million in Russia (OECD 1995 and Boycko, Schleifer, and Vishny 1995).

Voucher privatization appears to have failed, according to Pistor and Spicer, to perform in a fair, equitable way or to create effective rights in private property in either Russia or the Czech Republic. Fairness was lost because the population gained little or nothing as investors. Although those who immediately sold their vouchers were paid, those who exercised their vouchers and became shareholders either in firms or funds found themselves locked in by illiquid markets. Most transfers took place in large blocks off exchanges by big investors seeking or selling control. Since most of the funds were closed end, their shareholders could not redeem the share value from the fund. The authors concluded that "by and large, the citizens of Russia and the Czech Republic have become owners of the least performing assets in the economy, while the crown jewels have been reallocated in insider deals." (1996 at 30).

Shareholders' property rights appear to have been ineffective because of the power wielded by company insiders, particularly in Russia, and the continuing role of government. The funds in Russia held on average barely 6% of the outstanding shares of companies in which they invested. The major reason seems to have been that Russia gave managers and labor effective control over the privatizing firm's operations. Their power allowed them to prevent or slow market-oriented reform of their companies and hold down dividend payments that the funds needed to be profitable. In limited

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[*] Note that the OECD classified countries differently. For example, it grouped Poland and Kazakstan (OECD 1995). One explanation is that Pistor and Spicer wrote 18 months later amid changed circumstances.

cases, funds gained control of up to 25%, the maximum portion allowed to them by law, or even more by having other members of their industrial/ financial group buy shares in the same company, presumably gaining influence or even control through this stake. These funds performed successfully. In the Czech Republic, insiders were not protected and did not control big blocks of shares. Some funds joined forces to take control.

One could argue that these investment funds performed at least as well as could be expected. In Russia, 20-30 of the 636 funds "played an important role in the stock market and have an active portfolio with long-term perspectives for survival" (Pistor and Spicer 1996 at 8). Large funds, particularly in groups, succeeded. The problem from the perspective of financial democratization is that the concentration, scale, and group membership may signal that to succeed the funds need to be organized in a way that is more conducive to a corporatist than a pluralist system. Market participants with whom I spoke acknowledged that voucher privatization as implemented has worked against good governance by increasing the public's lack of confidence in the government.

Market responses signal dissatisfaction with the investment fund vehicle. Some funds and their management companies are transforming themselves into investment banks in Russia because fund profitability from trading is so limited. Unit trusts, if they are allowed to proceed, would be more flexible and may displace these investment funds. Funds in the Czech Republic are transforming themselves into joint stock companies, which are less regulated. Other transition countries became more cautious about using voucher privatization relying on funds, apparently in response to the problems in Russia and the Czech Republic.

To the extent the funds' problems are in their design, a more artful design could circumvent them. Certainly design factors undermined the funds. In Russia, tax is not indexed to inflation and is levied on income received by the fund and then distributed to its shareholders. The incentive structure may have motivated management companies advising the funds to levy excessive fees rather than make the funds profitable on-going financial intermediaries.[*] Loose regulation allowed "thousands of unlicensed investment companies" to flourish briefly (Pistor and Spicer 1996 at 18). Design problems in the Czech Republic do not appear to have been so severe.

The basic problems appear to be political and institutional, making voucher privatization and the supporting investment funds useful only as transitional devices. The key to the success of mass privatization, in one view, is that all of the essential steps must be taken to depoliticize firms, which means changing managerial behavior from "meeting the wishes of politicians to maximising profits"

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[*] Pistor and Spicer do not address this. They do note that the profits from new services go to the management companies rather than the funds. This could be appropriate in an industrial country, but in the transition countries it signals the possibility of serious conflict of interest between the management company and the shareholders of the funds

(Boycko, Schleifer, and Vishny 1995 at 153). Mass privatization is only one of these steps; others include ending state subsidies to firms after privatization, improving corporate governance, and ensuring product competition. They explain that Russian privatization failed because the highly political nature of privatization led to many compromises in design that would allow all interested groups to gain in some way. For example, limits on shareholder concentration protected managers of privatized SOEs from a strong dominant shareholder. Russia built into its version of voucher privatization limits on the shareholders' power to discipline managers. This suggests a central contradiction in voucher privatization: the goal of broad and equitable distribution of shares, designed to meet goals of good governance, may conflict with the demands of corporate governance, which may call for strong shareholder discipline of management. This contradiction may not be so stark in countries with more developed capital markets. In the U.S., where managerial independence was identified as a problem 65 years ago (Berle and Means 1932), well functioning markets allow dissatisfied shareholders to sell, signalling their discontent in the declining share price. In the illiquid markets of many transition countries, this option is often unavailable. The problems of the capital markets hinder the ability of voucher privatization to achieve its goals of good governance.

The implications of this analysis are that voucher privatization may be much more useful for initial distribution than for good governance in the long run. "Capital markets ... played an important role in the transfer and initial reallocation of company ownership (vouchers and shares), particularly in mass-privatizing countries. Individual shareholders (including insiders) have sold their shares, often through informal markets, and strategic investors have sought to establish controlling ownership stakes" (World Bank 1996 at 109). To allocate financial assets and their income streams equitably, voucher privatization needs institutional support, including liquid capital markets and effective prudential regulation. This is precisely what the transitional countries lacked when they privatized. As these supporting institutions take shape, the experience of Russia and the Czech Republic suggests that more traditional vehicles, such as unit trusts or mutual funds, will displace the voucher funds.

3. Credit markets and the role of secured lending in promoting growth and sharing wealth and income

Having described above how deeper credit markets are associated with economic growth and income distribution, here I ask whether the ability to secure debt with collateral contributes to deeper credit markets. The notion is that by offering a lender an interest in security (a security interest) a debtor can reduce the lender's risk. This prompts more lending than would have occurred without the security interest, deepening the credit market and promoting growth. The quality of the security interest is often presented as the the central issue. The World Bank (1989 at 87-8) wrote:

> The assignment and transferabilty of property rights ... indirectly [make] ... financial intermediation possible. They do this by allowing borrowers to offer security in the form of

mortgage sover real estate or other collateral. Some assets are better collateral than others ....

> When taking collateral, the lender is mainly interested in the efficient transfer of property rights, because the security is invoked only in case of default.... Mortgages over land and other real estate are therefore one of the best forms of collateral. ...If the entrepreneur has no suitable collateral, the risks to the lender increase dramatically. The lender will then need far more information and perhaps a share in the proceeds if the venture proves a success. ...
>
> In some countries other assets can serve as collateral. Inventories and other movable goods are inherently poor collateral because they have comparatively little value, are destructible, and can be sold privately and informally. They are difficult to use as collateral when left in the possession of the borrower. ...

So borrowers with good collateral have better access to credit than borrowers with poor or no collateral. To the extent that "good" collateral is limited by bad law or practice, lending opportunities would be limited and credit markets shallower than would otherwise be possible. Financial democratization would redress this problem. By correcting law or practice in order to extend the range of acceptable collateral, it would expand credit and promote growth, and by drawing more people into the formal economy it would distribute income, and possibly wealth, more broadly.[*]

An intense debate swirls around the link between the use of secured lending and the aggregate volume of loans. In some circumstances, the greater secured lending may be offset by reductions in unsecured lending. Lenders without security would reduce their loans because their protection would diminish as the borrower's assets were dedicated to the secured lenders. A zero- or negative-sum effect could worsen the debtor's position if the transaction costs of giving security were high. The economic effect of reduced unsecured lending could be bad. Prime borrowers that otherwise could have borrowed unsecured would bear the cost of giving security, which would increase transaction costs and reduce operational efficiency. Borrowers with good prospects but limited collateral -- such as a high tech firm -- would have more limited access to credit.[**] This important debate is not resolved here. For purposes of this paper, it injects a cautionary note into the idea that better law and practice for security interests would lead readily to financial democratization.

Several factors external to the regime for security interests also affect their use, at least in Asia (see Pistor and Wellons 1997). First, the government's economic strategy is critical. When

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[*] For a theoretical discussion of the way in which security interests promote efficiency by allowing creditors to enforce their rights in the property and reducing risk through the secured creditor's priority over other claimants, see Bebchuk and Fried (1995).

[**] For a discussion of other functions of security interests, see R. Scott 1986.

governments intervened in the economy and specifically in the financial system through directed credit, security interest regimes were relatively unimportant because security interests did little to affect the allocation of risk. To simplify, when a government requires banks to lend for designated purposes or borrowers, at specified interest rates and volumes, the banks expect the government to make good resulting losses they incur. The support could be direct to the bank or indirect, to the borrower, but in either case the support, rather than the collateral, reduced the risk to the lender. Indeed, Asian governments often precluded banks from enforcing security interests against politically important defaulting borrowers. When the economic strategy became market-oriented, security interests appeared to play a more significant role in a bank's lending decision. The role was sometimes complex. For example, Malaysia's economic strategy favored large, often foreign-owned, export-oriented companies and the security interest regime favored corporations (by granting them a wide range of assets to use as security). The implications are that efforts to improve a regime for security interests must take into account the government's economic strategy.

Even with a market-oriented economic strategy, events in the macro-economy and available substitutes for security interests affected their use. When macroeconomic conditions created a borrowers' market, competition reduced the ability of banks to require security. Substitutes came in many forms: from the law (e.g., transfers or retention of title by the creditor through hire purchase), relationships that promoted trust (such as informal guarantees by the patriarch of the borrower's family), or illegal activity (like reliance on enforcers to make debtors pay). In Taiwan, creditors relied increasingly on criminal sanctions for default on post-dated checks given by the borrower, and as the use of these sanctions grew during the late 1970s and early 1980s the share of secured lending in all loans fell. For the creditor, this had the advantage of putting the cost of enforcement on the government, which was precisely why the government ended the sanction in 1987: too many debtors were in jail. Immediately after the law changed, secured lending rose as a share of total loans, since creditors shifted back to rely more on security interests to reduce their risk. The implications are that as alternatives become relatively less effective, lenders will use security interests more if the economic strategy and macroeconomic conditions permit.

With these qualifications, evidence suggests that security interests do contribute to economic growth. Countries with legal regimes giving creditors high priority in corporate bankruptcy and enforceable loan contracts and with full accurate corporate reporting have "better-developed financial intermediaries." These elements are "positively associated with economic growth" (Levine 1997 at 28). The data for law were drawn from a study of 49 countries.[*] These regimes for security interests increase financial depth, whic other studies suggest augment the equitable distribution of wealth and income (see above).

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[*] Levine used another source (La Porta et al. 1996) for data about the legal regimes. A detailed study of five of the 49 countries raised questions about the classification of certain data for those five (see Pistor and Wellons 1997).

Security interests also affect access to credit, which in turn affects the distribution of wealth and income (see above). A weak legal regime, particularly because of a very limited range of assets in which a creditor can take effective security interests and poor administration and enforcement, limits the access of borrowers to finance, according to ample evidence. De Soto stated the general problem in describing the way inadequate or non-existent property rights and costly but deficient registries affect business in Peru (de Soto 1989). Those in the formal sector bear inordinately high costs and those in the informal sector are severely limited in the businesses they can pursue. In Bolivia, for example, the legal system is structured so that "most lenders require real estate as collateral. This practice makes it very difficult for merchants, mineowners, industrialists, professionals, and farmers to borrow against equipment inventory, crops, or anything else they might use in the course of their trade or business" (Fleisig, Aguilar, and Pena 1997, at 65). The effect is to raise interest rates substantially and to deny access to credit. In India, enforcement delays of more than a decade are one reason that at least 95% of all bank loans are secured, often by multiple forms of collateral in the hope that at least one might eventually produce enough to offset some of the costs of default. This has a severe impact on transaction costs and does little to reduce uncertainty.

These weak legal regimes drive borrowers into the informal sector. In parts of Latin America, it appears that one is either in the formal system and subject to its costs and benefits or in the informal system, which reduces some of the formal costs but imposes others while severely narrowing one's options (de Soto 1989). At least in Asia, however, informal lenders may use the legal system to reduce their risk even if they do not use the regime for security interests. In Taiwan, informal lending flourished when criminal sanctions existed for post-dated checks and its relative share of total lending declined when the law changed in 1987. In Korea, the courts recognized an informal device called *yangdo dambo* used in the curb market to transfer title in collateral to the lender while a loan was outstanding. The problem with these substitutes was that they were costly. The criminal sanctions imposed a cost to government that ultimately proved unacceptable in Taiwan. Irregularities with the *yangdo dambo* meant that a defaulting debtor would lose the entire value of the collateral even if it substantially exceeded the debt (Pistor and Wellons 1997) .

The implications of this analysis are that efforts to improve regimes for security interests should be sensitive to the constraints that can make security interests less useful: the government's economic strategy, conditions in the macro-economy, the existence of cheaper substitutes, and conditions in which an increase in secured lending simply offsets a fall in unsecured loans. Subject to this, it appears that projects should continue to improve property rights, broaden the range of acceptable collateral (to the point of including inventory and accounts receivable), streamline and centralize registration, provide mechanisms for speedy enforcement (some of the Asian countries allow a creditor to enforce its claim in less than six months when courts are used and faster with self-enforcement), and set clear rules for priority in bankruptcy. These actions would promote both economic growth and good governance, according to the literature, and, assuming enforcement was even-handed between creditors and debtors, be consistent with financial democratization.

4. Market imperfections, finance for micro-enterprise, and the distribution of income and wealth

Finance for micro-, small, and even medium-sized enterprise offers a type of financial democratization that is similar to that provided by effective security interests. The notion is that by broadening financial services available to these enterprises, one allows them to grow, broadening th edistribution of wealth and income and possibly contributing to ecnomic growth. This logic applies to all three firm sizes.

It is generally accepted that access to credit is seriously limited for these enterprises. Banks explain that these small borrowers are much less creditworthy than big blue chip borrowers. The small borrowers' lack of acceptable collateral is treated in the previous section. A second problem they face is that some fixed lending costs are not a function of the size of the loan, so bigger loans enable banks to earn a higher profit than small loans (Klitgaard 1991 at 46). The banks prefer to make larger loans to larger borrowers, but not just because of the borrowers' creditworthiness. And other reasons may exist:

> With respect to credit allocation to small firms, market failure may occur if large firms have control over credit markets and apply bargaining power to obtain loans on privileged terms. Also, large firms may get privileged terms if they have an implicit governmnt guarantee, in the sense that they are more likely to be rescued by governmnt than small firms (Wade 1990 at 12-13).

These market imperfections are used by economists to justify corrective government action. . "These cases can provide a rationale for compensating government intervention to increase small firms' access to credit. .... Such arguments can be used to provide a justification for a *functional* or horizontal industrial policy which is consistent with the principles of neoclassical economics. ..." (Wade 1990 at 12-13). Indeed, almost every country in the world has special programs to promote lending to small firms, though the techniques used to support the different sized firms vary. A typical example, for micro-enterprises, is Grameen Bank in Bangladesh, which relies on local evaluation and sanctions when it lends for very small projects.

Political scientists justify government action as improving governance. Campos and Root concluded that programs to support SMEs were important, as noted above, because they signaled people that the sacrifice required by rapid development would benefit them, giving more jobs. The programs to promote small and medium-sized enterprises lowered unemployment rates as SMEs proliferated, inspiring confidence that jobs would become available (Campos and Root 1995 at 75). Most of the high performing Asian economies, they said,

> introduced support systems for small- and medium-sized enterprises .... SMEs generally have

> difficulties obtaining long-term credit to finance capital improvements. They also find it hard to obtain better technology and acquire the necessary skills to use the technology and break into markets, particlarly export markets. Hence, a nontrivial SME sector cannot be established without external assistance. The support programs in three of the ... most advanced [countries]--Japan, Korea, and Taiwan--have produced modestly positive results. (Campos and Root 1995 at 60).

The important points for this paper are that SMEs needed help, the help included finance, and it worked: SMEs played an important role in the countries' development. In Korea, SMEs' share of manufacturing value added rose from 24% in 1976 to 35% in 1988, while in Taiwan SMEs accounted for 60% of all value added in 1989 (Campos and Root 1995 at 61-4),

The prescription of direct government intervention is not universally accepted because of the fear that a government supported by weak institutions would abuse its role. The World Bank argued that goverments should be reluctant to give direct credit for rural finance in transition countries even though the sector was in crisis. The World Bank acknowledged the gaps: "New banks are usually reluctant to serve agriculture, because the risks are high, profitability is low, credit histories are short or absent, and land is poorly registered and difficult to collateralize." But the Bank did not propose direct government intervention. Instead, it recommended "creating cooperative financial institutions...[as] a constructive approach to self-sustaining finance. Credit cooperatives--which already exist in Hungary, China, and Vietnam--have many strengths: active peer monitoring of borrowers, close links with clients, and an emphasis on mobilization of savings. These benefits can be undermined, however, if the cooperatives depend on government as the source of finance" (World Bank 1996 at 105), presumably because of the long and often sad history of credit union cooperatives in many countries.

The World Bank proposed, further, that certain types of market instruments, or contractual arrangements, substitute for direct government action. Since non-bank financial institutions (NBFIs), rather than banks, tended to finance SMEs, "leasing--of machinery, say, or vehicles--offers many advantages over traditional bank loans, not least that it can work well even where collateral laws are still extremely weak.... [L]easing has come to finance a large share of new investment in transition economies: nearly a third in the case of Slovenia, and about one-sixth in some other countries. With most leases awarded so smaller enterprises, the average lease has likewise tended to be small." The Bank observed that law must be strengthened for NBFIs to become more effective (World Bank 1996 at 106).

The implications, then, depend on one's view of the government's role dealing with market imperfections. The case for intervening to promote good governance is drawn from Asia, where SMEs played an important role in some of the successful export-oriented strategies (notably Korea and Taiwan). The case for intervening to support SMEs economically is stronger to the extent that government action supports market activity. The types of help given by Asian governments may be a useful model.

G. Financial Markets and Neutral Rules

As financial markets develop, the demand for neutral regulation should produce greater transparency, predictability, and accountability.

Financial markets need regulation. Stiglitz explained the reason, describing capital markets, in the following way:

> What makes capital markets interesting and important is that information is imperfect. With imperfect information markets are, in general, not constrained Pareto efficient. There is no presumption in favor of unfettered markets.
>
> [One reason is that]... much of the return in capital markets consists of rent seeking. Your knowing, a minute before anyone else does, that Exxon has made a major oil discovery may make you a fortune by buying Exxon stock; but it does not increase the efficiency with which society's resources get allocated. Much of the innovation in the financial sector entails the recording of transactions more quickly, but is society really that much better off as a result. Someone might get the interest that might otherwise have accrued to someone else, but have more goods been produced or have they been allocated more efficiently? ... In short, there is no a priori basis for arguing the government should not intervene in the market, and there seem to be strong arguments for government intervention. ... (Stiglitz 1993 at 15-16)

Major reasons given to regulate banking include the need to sustain depositor confidence, to protect against systemic risk, to reduce deposit insurance costs, and because governments do bail out banks to prevent a crisis, to protect the state's purse.

Although financial markets may need regulation, what would require these rules to be transparent and predictable? In at least five countries in Asia -- India, Japan, Korea, Malaysia, and Taiwan -- laws evolved as one tool of government economic strategy from 1960 to 1995. Each of these countries had a full set of laws in place in 1960 (see Pistor and Wellons 1997). When policy favored direct government intervention, bureaucratic laws evolved and as policy became more market-oriented, rights-based laws developed. Rights-based law defines who has the right to act, rather than what they must be do. It provides a procedural framework on which the private sector may draw and limits government action. The sources are statutes, cases, and regulation, all are published, and change is takes place through a formal process in the legislature, courts, or executive. Rights-based laws are transparent and predictable, and the government agencies making, implementing, and enforcing them are accountable. Bureaucratic law controls economic behavior in order to implement government policy, delegating wide discretion to bureaucrats without subjecting them to significant procedural constraints. As a result, bureaucrats make and amend many of the rules, which are often not generally published. An example would be Japan's administrative guidance. No one of these five countries had a pure type of legal system. Rather, each mixed bureaucratic and rights-based laws. China was different from the five, continuing to rely on bureaucratic law as its economy evolved.

The implications depend on the state of the country's legal system. The experience of five Asian countries with legal systems in place suggests that a market-oriented economy needs rights-based law. This does not mean that all countries will have laws with identical content or procedures. Quite the contrary, since the laws of the five countries in Asia differed substantially along both dimensions. The story of China suggests that at least some transition countries will not be willing or able to emulate quickly countries that had legal systems in place for decades or longer. China had chosen to abolish its legal system in the 1960s. The institution building required to install a working legal system from the ground up is very time consuming and costly. For these countries, a transparent and predictable legal system, to support a liberalizing financial sector, will take a long time to achieve.

H. Financial Market Power and Declining Central Government Power

As financial markets increasingly serve central and local governments, the power of the central government to act unilaterally declines and its obligation grows to act with greater transparency, predictability, and accountability.

1. Central government use of financial markets and the need for transparency

As governments come to rely more on financial markets to fund their operations rather than manipulating the financial system to raise cheap funds, they must meet market standards to borrow and abide by the rules. This erodes the governments' power to control market players, in turn promoting good governance.

The sovereign's power to make the rules gives it the option of changing the rules after it borrows funds. It may either reneg on its contract with the lenders or change the general rules in a way that allows it to reneg (for example, by setting an upper limit on interest rates that is below what it agreed to pay). Rulers have routinely discovered the short-term advantages of this behavior, particularly in crisis. North and Weingast (1989) demonstrated the disastrous long-term consequences of this behavior for the Stuart kings of England in the early seventeenth century and showed how the solution was a step toward good governance in England. The Stuarts had continued a late Tudor borrowing policy for their government that was unsustainable, then reneged on their obligations to repay. Their access to fresh loans from financial markets dried up. The Glorious Revolution of 1688 solved this problem by putting in place institutions that would make the Crown's promise to repay credible and, incidentally, laid the foundation for modern capital markets. The institutions included the legislature's fiscal powers, courts independent of the king, and a private bank (the Bank of England) that, as the crown's agent to raise and service debt, could relate servicing to borrowing. The central thesis of the article is the importance for economic growth of rules that credibly bind the sovereign. The important point for this paper is that the financial markets forced this discipline on the crown. In a contemporary example, the Indonesian government canceled contracts for its loans to Indonesian banks in 1987 as part of its effort to stem a foreign exchange crisis. The action dramatically slowed the growth of the nascent money markets because it indicated the willingness of the sovereign to reneg in crisis. More binding commitments were necessary for growth to resume (Cole, Scott, and Wellons 1995).

The process may take a long time. In Japan, the pivotal role of the government in the financial system came under intense public scrutiny in the early 1990s and in 1996 the government proposed a Big Bang that would radically shift to a market-oriented system. The seeds for this dramatic change were sowed twenty years earlier, in the mid-1970s, when the government found itself forced to borrow substantially from Japanese banks to fund fiscal deficits induced by the oil shock and recession. At that point, the government, unwilling to accept market rates for the debt, was able to compel the banks to lend to it at lower rates (or, stated another way, to accept low-priced government paper for which there was otherwise limited demand). But the balance of power began to shift from the government to the banks, which expected a *quid pro quo,* including broader powers. Over the next decades, the financial markets gradually liberalized. When Japan's government borrowed substantially in the early 1990s, it did so at market rates. The substantial erosion of its power was due to many factors, including its earlier need for funds from the financial sector. The implications are that assistance projects should be structured to reflect realistically the time needed to successfully complete them.

2. The financial system and fiscal decentralization

As state or local government agencies or enterprises raise funds on financial markets, they increase their independence from the central government, provided they borrow prudently. This topic is explored in another session of this conference.

I. Financial Market Structure and Relations between Interest Groups and the State

The structure of financial markets may be key to an important element of governance, the type of relations between interest groups and the state. As described above, these relations may be pluralist or corporatist, or some mix. Corporatist relations allow a government to play a key role guiding the economy.

In East Asia, governments used corporatist relations to guide market activity, according to Wade and many others. The idea is that the government, with its capability to balance rights among various interest groups, can constrain the groups' activities. The government's ability to balance rights derives from the existence of the corporatist system. In the context of the financial system, this means that the government exercises substantial discretion in regulating the entry and powers of, for example, commercial banks, other banks, and securities companies, limiting each from encroaching on the turf of the others. The desire of each to protect itself from the others augments the leverage the government derives from its broad power to make and interpret the rules governing entry, segmentation, and concentration in the financial system (for a general description see, e.g., World Bank 1996 at 98).

The logic of this view is that as the structure of the financial system liberalizes and the corporatist system breaks down, the government loses a basic tool to guide the economy, and governance changes. The financial system plays a key role because of its role allocating resources within the economy. Wade identifies the government's ability to guide the market as due in part to its control of the financial system and its having subordinated "private financial capital ... to industrial capital" (Wade 1990 at 27). The corporatist system is associated, in Asia at least, with bureaucratic laws that neither are transparent or predictable nor, outside the government, provide accountability (Pistor and Wellons 1997), and this is particularly true in the financial sector. As a pluralist system replaces the corporatist one in the financial sector, one of the government's tools for guiding the economy is lost. In Japan, many hope that the financial system's Big Bang will reduce the power of the bureaucracy over the economy.

The implications of this are that, to relate financial development and good governance, one must promote pluralism. This requires attention to rules governing entry and operations in different parts of the financial sector, so that substantial cross-competition can take place. One must work closely with regulators. It also requires attention to anti-trust policy.

J. Conclusion: Policy Implications

The financial system appears to affect governance through many channels: signalling, replacing substitutes, broadly distributing financial assets and hence wealth and income, contributing to economic growth (and generally increasing the stake of much of the populace in the country's performance), increasing the use of neutral rule-based institutions, exercising market power over the central government or to support decentralization, and using pluralistic rather than corporatist structures. Proposals for action should address each of these channels. Some are identified in each section above.

One can speak of financial democratization in terms of four levels, the financial system, the government's use of financial markets, the financial structure, and individual financial markets or instruments.

- The strongest evidence that finance can play a role in good governance comes at the systemic level. The financial system can displace activities, such as organized crime, that undermine good governance. It can signal early the harmful consequences of certain government policies. As the financial system grows deeper and broader, it contributes to the growth of the middle class as asset holders with an interest in the transparency, predictability, and accountability of government

- When the government relies on financial markets, they can force governmental issuers to provide accurate information, creating transparency, and to perform consistently, creating predictability. Here too the impact can be strong.

- The financial structure can reduce the government's ability to straddle and guide a corporatist system. A financial structure permitting more access and reducing segmentation probably supports the pluralism that is useful for good governance, but we lack strong evidence.

- At the level of individual financial markets or instruments, the evidence of a useful impact on governance is more qualified. Three techniques examined in this paper are voucher privatization, collateral, and finance for micro-enterprises. The last two arguably promote both growth and good governance, but voucher privatization faces growing criticism as a long-term way to promote good governance or even corporate governance.

Perhaps the policy implications vary by type of country. Prescriptions for transition countries may vary from the observations about the actual beneficial effect of direct interventions in the financial system by government in Asia. One case is the contrast between the World Bank's prescriptions for SMEs and the useful effect of credit and other programs in Asia. The different approaches may reflect fundamentally different ideologies held by their protagonists. But I believe there is another explanation   The two approaches reflect the fact that transition countries lack the instutitional structure that made the interventions succeed in Asia. Campos and Root argued that a complex system of institutional relationships allowed a host of direct interventions by the government that had the effect of encouraging sacrifice in the short-term because of the credible prospect of equitable sharing of the fruits of economic growth. Wade described a corporatist system relating interest groups and government. Transition countries generally lack these.

This suggests that in transition countries, programs to deepen and broaden the financial system are a better bet for financial democratization than programs for individual instruments. Policies to strengthen the rules governing security interests seem warranted, if not essential for good governance, as seen in Asian countries. Policies to support micro-enterprise are based on the recognition by economic theory that government action is appropriate in certain circumstances.   Some of these polices worked effectively in Asia. More needs to be learned about how these policies, used to help SMEs in Asia, would promote good governance elsewhere.

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Impact of the Financial System on Governance: Assumptions about the Steps

A. The financial system or relevant parts (below), if broadened and deepened, ...	**B. Affect the intermediate variables below**...:	**C. Which in turn affect good governance by increasing:** trans-parency	predict-ability	account-ability	role of NGOs	civil society
1a. **Entire financial system**: broader, deeper financial systems .. °	1. Financial markets publicly ° signal political economic problems faster than a managed system does	signalling forces more transparency and predictability, and imposes accountability (an hypothesis)				yes
1b. **Entire financial system** ... °	2. Filling market gaps reduces ° substitutes (e.g., organized crime)	formal market generates these three factors more than informal markets				yes
1c. **And** entire financial system... °	3. System (A1c) and components (A2a-c) affect all four items below:					
2 Financial system **components**: a. **Capital markets**: broader distribution of ownership (through privatization, for example)... °	a. Increased equality of income and wealth °	the growing middle class and the institutional investors representing them demand ° greater transparency, predictability, and accountability to manage their assets			funds let people ° sup-port NGOs	
b. **Credit markets**: access by a broader range of entrepreneurs to credit (through security interests, for example)... °	b. Increased growth of GNP per capita ... °					
c. **Financial resources for micro-enterprises:** access by micro-enterprises to more, and a broader range of, financial resoures ... °	c. Increased reliance on ° neutral rule-based institutions .	rights-based law is transparent, predictable, and gives accountability			yes	
3. **Government reliance** on financial markets ... °	3. Decentralization of power °	government must disclose accurate data about itself to create confidence				yes
4. **Financial structure**: more access, less segmentation ... °	4. More pluralistic structure ° displaces corporatist tendencies	government is less able to mani-pulate finance for political purposes				